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OO RUEHGI RUEHMA RUEHROV
DE RUEHKH #1171/01 2170810
ZNR UUUUU ZZH
O 040810Z AUG 08 ZDK CTG NUMEROUS REQUESTS
FM AMEMBASSY KHARTOUM
TO RUEHC/SECSTATE WASHDC IMMEDIATE 1507
INFO RUCNFUR/DARFUR COLLECTIVE

UNCLAS SECTION 01 OF 02 KHARTOUM 001171

DEPT FOR AF/SPG, AF/EPS, EEB/IFD/OMA, EEB/IFD/OIA
DEPT PLS PASS USAID FOR AFR/SUDAN, TREASURY FOR OFAC

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN SU
SUBJECT: Sudanese Banking Sector: Bad Loans Persist, but Foreign Firms See Bright Future

REF: KHARTOUM 1035

KHARTOUM 00001171 001.2 OF 002

¶1. (SBU) SUMMARY: On 17 July, local daily "Al-Rayaam" ran a story outlining problems of embezzlement and bad debts in the Sudanese banking sector, where an estimated 22% of all loans are deemed to be non-performing. Despite successive economic reforms over the past two decades, the volume of non-performing loans has been a recurring issue for Sudanese banks, one which observers blame on long-standing political interference aimed at channeling financial resources towards affiliates of the ruling National Congress Party (NCP). Nevertheless, over the past several years, the sector has seen large inflows of foreign investment from the Middle East, as a result of a booming economy and strong support from the now independent Central Bank of Sudan. Foreign investment is likely to continue, as foreign bankers report that the market is quite profitable and poised for continued growth and opportunity. END SUMMARY.

ORIGINS OF THE MODERN BANKING SECTOR
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¶2. (SBU) On July 27, econoff met with Ali Abdallah Ali, a professor of economics at Sudan University for Science and Technology and a renowned banking expert, to discuss the development of the Sudanese banking sector. According to Ali, the sector has undergone several evolutions since Sudanese independence in 1956. First, upon inheriting a legacy of colonial-era foreign banks, President Nimeiry nationalized them in 1970. Soon after, he granted permission for the establishment of the first Islamic bank, which opened the door for numerous others. (Note: In Islamic banking, the charging of interest is considered "riba" (usury) and is prohibited. Instead, banking is conducted under various purchase and sale agreements or on the basis of profit/loss sharing contracts that determine ex-post rates of return. End Note.)

¶3. (SBU) Conventional (i.e. non-Islamic) banking endured until the 1984 Civil Act, which required banks to be fully compliant with Shariah rules. Ali stated that the emergence of Islamic banks was a welcome development to the banking system, as it attracted considerable deposits from customers who previously were reluctant to deal with banks they considered un-Islamic. The complete "Islamization" of the banking sector was accomplished with the advent of the present government in 1989, he said. (Note: In accordance with the Comprehensive Peace Agreement, banking in the North is to remain Islamic while the South has adopted conventional banking. End Note.)

'POLITICAL' BANKS
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¶4. (SBU) Many banks were privatized during the liberalization program begun in 1992, but according to Ali, they remained organs of the state, specifically the NCP. He alleges that the resources of the banking system were directed towards empowering certain

businesses and clients, who in turn made payouts to the NCP. To enable this system of patronage, banks were stocked with Islamic fundamentalists appointed not for their acumen but for their loyalty, and lending guidelines were kept loose and arbitrary. But by allowing political considerations rather than sound lending practices to direct decision-making, banks soon became saddled with bad loans. Ali observed that the accumulation of such loans continues to plague Sudanese banks and impedes efforts to clean up their balance sheets, despite an otherwise successful IMF reform program that went into effect in 1997. In 2006, for example, severe liquidity problems as a result of mismanagement at Omdurman National Bank required significant government intervention. According to Ali, Omdurman National Bank is "the army's bank."

FOREIGN DIRECT INVESTMENT
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¶5. (SBU) Despite these problems, over the past several years the continuation of the IMF reform program and a booming economy have attracted copious foreign investment in the sector from the Middle East. In his April 2008 State of the Republic address, President Bashir asserted that foreign investment in the banking sector over the past two years approached $1 billion, according to a report in the daily "Sudan Tribune." The most prominent foreign investors include Byblos Bank of Lebanon, Al Salam Bank of Bahrain, and Dubai Islamic Bank (DIB), which acquired 60% of Bank of Khartoum (BOK) from the Government of Sudan (GOS) in 2005.

¶6. (SBU) Econoff recently spoke with Fadi Salim Al Faqih, General Manager of BOK, on the outlook for the Sudanese banking sector. Al Faqih, a Jordanian brought in by DIB to run BOK, explained that the banking sector is expanding to meet the needs of the growing economy, and the Central Bank has been quick to adapt, encouraging reform as well as consolidation within the sector. (Note: In January of 2008, BOK merged with Emirates and Sudan Bank, which was

established in Sudan in 2005 by investors from the Gulf. As a result, the GOS stake in BOK has been reduced to 10%. End Note.) Al Faqih noted that despite the influx of foreign competition, profit margins remain high at 10-12%, compared to margins of 2-3% in mature markets. He said that while BOK is principally engaged in commercial banking, it sees retail banking as an area of growth and has been offering new products such as home and auto loans.

EFFECT OF U.S. SANCTIONS
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¶7. (SBU) Since BOK is now 90% in private (mostly foreign) hands, Al Faqih is seeking to have it removed from the U.S. Treasury Office of Foreign Assets Control (OFAC) list of Specially Designated Nationls (SDNs --see reftel). He stated that while new foreign entrants cannot compete with BOK (and its 51 branches) as local banks, they are well capitalized and not designated as off-limits by OFAC, giving them an inherent advantage against BOK in dealing with multinational firms in areas such as trade finance. (Note: Based on guidance from OFAC, Post has provided BOK with information on how to initiate a formal request for delisting. End Note.)

COMMENT
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¶8. (SBU) Sudan's robust, oil-driven economic growth and the eagerness of Middle Eastern investors to invest capital in Islamic finance have been a boon for the country's banking sector, which after years of mismanagement is beginning to break free from government meddling. While the experience of Arab investors in Sudan has been mixed overall, their experience in banking has been largely positive, as new foreign banks have avoided the pitfalls previously encountered by their domestic counterparts. Other independent reports have also projected rapid growth for Islamic banking throughout much of Africa. (See next para for additional information.) Though OFAC's designation has limited the growth of BOK, new foreign entrants to the banking sector remain unencumbered and appear to be thriving. This seems to indicate that the primary effect that U.S. sanctions have in inhibiting the growth of the

banking sector is by limiting the participation of large multinational corporations (and the financial services they require) in the Sudanese economy.

REFERENCE
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¶9. (SBU) For more on the growth of Islamic banking in Africa, see: Islamic Finance Explores New Horizons in Africa (Moody's, March 2008.) The report asserts that the market for Islamic finance in Africa has barely tapped its potential. It states that "conservatively assuming that the banking entrenchment in Africa represents an average 50% of its total GDP, the Islamic finance market on the continent is potentially worth close to $235 billion... [Whereas] the actual depth of Shari'ah-compliant financial intermediation in Africa was only $18 billion as of year-end 2007." Sudan accounts for over half of Islamic finance assets in Africa, according to the report, and is on the cutting edge of Islamic finance there; in 2007, Berber Cement Co., based in Sudan, issued the first ever African sukuk (Islamic bond) in a $130 million transaction for the financing of a cement project on the Nile.

FERNANDEZ